

MANAGING HOUSING BUBBLES IN REGIONAL ECONOMIES UNDER EMU: IRELAND AND SPAIN

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The international financial crisis has inflicted substantial damage on many economies around the globe. In Ireland and Spain, the impact has been particularly severe, due largely to the collapse of housing bubbles in both economies. The significant economic instability caused by the abrupt ending of such housing market bubbles highlights the importance of developing policy instruments to manage housing markets and to prevent dangerous bubbles from emerging. Our recent paper** shows how the advent of EMU relaxed financial constraints in Ireland and Spain, allowing for a more rapid expansion of the housing stock in those countries to meet their specific demographic circumstances. If this process had been properly managed there would have been significant benefits for both economies. However, because the housing boom was not controlled by governments these two economies have suffered serious damage. Due to the idiosyncratic nature of housing markets, monetary policy, as implemented by the ECB, cannot be used to manage housing markets within regional economies in EMU. However, the paper argues that fiscal policy instruments can and should be used to manage housing bubbles and thereby avoid the severe damage caused to economies by their collapse.

The Drivers of the Housing Market

The rapid rise in house prices in Ireland over the past decade has meant that adults continued to share accommodation (either with parents or friends) to an extent that was unusual by EU standards at a time when living standards, measured in terms of real disposable income, rose dramatically. The natural increase in the adult population alone means that around 20,000 additional dwellings a year are needed in Ireland to take account of the rising number of adults. The role of demographic factors, in addition to variables such as disposable income, the per capita housing stock and the user cost of housing, is reflected in the model of house prices for Ireland and Spain which is specified in the paper.

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EMU and the Cost of Capital

The advent of EMU had a major impact on the cost and availability of credit in many member states of the Euro Area. Prior to EMU countries such as Ireland and Spain faced a significant exchange risk premium attached to borrowing in their own currency relative to borrowing in Deutschemarks. This raised the cost of capital for housing in these countries relative to Germany and meant that, prior to EMU, even with similar income levels and demographics, the optimal long-run stock of dwellings would have been lower than in Germany or the Netherlands. The advent of EMU, reducing the cost of capital permanently for households, raised the optimal long-run stock of dwellings.

The liberalisation of credit markets following EMU had a second important implication. It allowed the domestic banking systems in Ireland and Spain to borrow substantially from abroad without any exchange rate risk. This borrowing from abroad, as reflected in the rapid increase in the net foreign liabilities of the banking system after 2003, was used to finance the domestic housing booms in both Ireland and Spain. This increase in foreign borrowing through the domestic banking system was the counterpart to the major increase in the balance of payments deficit which emerged in Ireland after 2003. It should be noted, however, that while EMU played an important role in relaxing credit constraints in Ireland and Spain, the wider liberalisation of financial markets also had an effect in countries outside the Euro Area.

The Role of Building in the Economy

The rapid expansion of the building and construction sector in Ireland and Spain resulted in a sharp increase in the share of housing investment in GDP. For Ireland and Spain, housing investment in 2005 accounted for record shares of GDP of 14 and 9 per cent respectively compared to a more normal 5-6 per cent of GDP in countries such as France and Germany. The housing price and output booms in Ireland and Spain had a major impact on both these economies. High prices for housing and the enhanced profitability of the sector resulted in a dramatic increase in the labour force employed in that sector. While an influx of immigrants moderated the impact on wage rates, it was not sufficient to prevent wage rates throughout the two economies from rising much more rapidly than in the rest of the EU, so that both economies lost competitiveness. The crowding out of the tradable sector of the economy by the building and construction sector was reflected in the rapid decline in the export market share for both economies and in the increase in their balance of payments deficits.

Managing the Housing Market under EMU: Policy Issues

Prior to EMU, countries could use monetary policy to manage the domestic housing market. However, under EMU monetary policy is targeted at the Euro Area inflation rate and, because of the idiosyncratic nature of the housing sector across the Eurozone, the stance of monetary policy will only help to control housing bubbles by accident. While more vigilant financial regulation should play a crucial role in ensuring the stability of the financial system, in a financially integrated world where banks operating in one economy are regulated by different national authorities, better financial regulation may not be sufficient to manage the domestic housing market. This paper argues that, under these circumstances, the best instrument available to governments to manage regional housing markets is fiscal policy. For countries such as Ireland

and Spain, this may entail a shift in focus away from the Stability and Growth Pact target of not running a deficit to the requirement to run large surpluses for a number of years where there is a housing boom. In addition, more active use of taxation would manage risks to the wider economy arising from housing market bubbles by specifically targeting the housing sector.

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